

section 1 (a) or (b) and the tax at the 87-percent rate shall each be computed before the allowance of any credits against the tax. Where the alternative tax on capital gains is imposed under section 1201(b), the 87-percent limitation shall apply only to the partial tax computed on the taxable income reduced by 50 percent of the excess of net long-term capital gains over net short-term capital losses. Where, for purposes of computations under the income averaging provisions, section 1201(b) is treated as imposing the alternative tax on capital gains computed under section 1304(e)(2), the 87-percent limitation shall apply only to the tax equal to the tax imposed by section 1, reduced by the amount of the tax imposed by section 1 which is attributable to capital gain net income for the computation year.

(b) *Taxable years beginning after December 31, 1970.* If, for any taxable year beginning after December 31, 1970, an individual has earned taxable income which exceeds his taxable income as defined by section 1348, the tax imposed by section 1, as amended by the Tax Reform Act of 1969, shall not exceed the sum computed under the provisions of section 1348. For imposition of minimum tax for tax preferences see sections 56 through 58.

[T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.1-3 Change in rates applicable to taxable year.

For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated by T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.1(h)-1 Capital gains look-through rule for sales or exchanges of interests in a partnership, S corporation, or trust.

(a) *In general.* When an interest in a partnership held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under section 751(a)), collectibles gain, section 1250 capital gain, and residual long-term capital gain or loss. When stock in an S corporation held for more than one year is sold or exchanged, the transferor may recognize

ordinary income (e.g., under sections 304, 306, 341, 1254), collectibles gain, and residual long-term capital gain or loss. When an interest in a trust held for more than one year is sold or exchanged, a transferor who is not treated as the owner of the portion of the trust attributable to the interest sold or exchanged (sections 673 through 679) (a non-grantor transferor) may recognize collectibles gain and residual long-term capital gain or loss.

(b) *Look-through capital gain*—(1) *In general.* Look-through capital gain is the share of collectibles gain allocable to an interest in a partnership, S corporation, or trust, plus the share of section 1250 capital gain allocable to an interest in a partnership, determined under paragraphs (b)(2) and (3) of this section.

(2) *Collectibles gain*—(i) *Definition.* For purposes of this section, *collectibles gain* shall be treated as gain from the sale or exchange of a collectible (as defined in section 408(m) without regard to section 408(m)(3)) that is a capital asset held for more than 1 year.

(ii) *Share of collectibles gain allocable to an interest in a partnership, S corporation, or a trust.* When an interest in a partnership, S corporation, or trust held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the transferor shall recognize as collectibles gain the amount of net gain (but not net loss) that would be allocated to that partner (taking into account any remedial allocation under § 1.704-3(d)), shareholder, or beneficiary (to the extent attributable to the portion of the partnership interest, S corporation stock, or trust interest transferred that was held for more than one year) if the partnership, S corporation, or trust transferred all of its collectibles for cash equal to the fair market value of the assets in a fully taxable transaction immediately before the transfer of the interest in the partnership, S corporation, or trust. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, S corporation, or trust, the same methodology shall apply to determine the collectibles gain recognized by the transferor, except that the partnership, S corporation, or trust

shall be treated as transferring only a proportionate amount of each of its collectibles determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. With respect to the transfer of an interest in a trust, this paragraph (b)(2) applies only to transfers by non-grantor transferors (as defined in paragraph (a) of this section). This paragraph (b)(2) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of an interest in a partnership, S corporation, or trust.

(3) *Section 1250 capital gain*—(i) *Definition*. For purposes of this section, *section 1250 capital gain* means the capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent.

(ii) *Share of section 1250 capital gain allocable to interest in partnership*. When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under section 1(h)(7)(A)(i) in determining the partner's unrecaptured section 1250 gain the amount of section 1250 capital gain that would be allocated (taking into account any remedial allocation under § 1.704-3(d)) to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its section 1250 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the section 1250 capital gain recognized by the transferor, except that the partnership shall be treated as transferring only a proportionate amount of each section 1250 property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or

exchange. This paragraph (b)(3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest.

(iii) *Limitation with respect to net section 1231 gain*. In determining a transferor partner's net section 1231 gain (as defined in section 1231(c)(3)) for purposes of section 1(h)(7)(B), the transferor partner's allocable share of section 1250 capital gain in partnership property shall not be treated as section 1231 gain, regardless of whether the partnership property is used in the trade or business (as defined in section 1231(b)).

(c) *Residual long-term capital gain or loss*. The amount of residual long-term capital gain or loss recognized by a partner, shareholder of an S corporation, or beneficiary of a trust on account of the sale or exchange of an interest in a partnership, S corporation, or trust shall equal the amount of long-term capital gain or loss that the partner would recognize under section 741, that the shareholder would recognize upon the sale or exchange of stock of an S corporation, or that the beneficiary would recognize upon the sale or exchange of an interest in a trust (pre-look-through long-term capital gain or loss) minus the amount of look-through capital gain determined under paragraph (b) of this section.

(d) *Special rule for tiered entities*. In determining whether a partnership, S corporation, or trust has gain from collectibles, such partnership, S corporation, or trust shall be treated as owning its proportionate share of the collectibles of any partnership, S corporation, or trust in which it owns an interest either directly or indirectly through a chain of such entities. In determining whether a partnership has section 1250 capital gain, such partnership shall be treated as owning its proportionate share of the section 1250 property of any partnership in which it owns an interest, either directly or indirectly through a chain of partnerships.

(e) *Notification requirements*. Reporting rules similar to those that apply to the partners and the partnership under section 751(a) shall apply in the case of sales or exchanges of interests in a

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partnership, S corporation, or trust that cause holders of such interests to recognize collectibles gain and in the case of sales or exchanges of interests in a partnership that cause holders of such interests to recognize section 1250 capital gain. See § 1.751-1(a)(3).

(f) *Examples.* The following examples illustrate the requirements of this section:

Example 1. Collectibles gain. (i) *A* and *B* are equal partners in a personal service partnership (*PRS*). *B* transfers *B*'s interest in *PRS* to *T* for \$15,000 when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted basis	Market value
Cash	\$3,000	\$3,000
Loans Owed to Partnership	10,000	10,000
Collectibles	1,000	3,000
Other Capital Assets	6,000	2,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	20,000	32,000

	LIABILITIES AND CAPITAL	
	Adjusted basis	Market value
Liabilities	2,000	2,000
Capital:		
<i>A</i>	9,000	15,000
<i>B</i>	9,000	15,000
Total	20,000	32,000

(ii) At the time of the transfer, *B* has held the interest in *PRS* for more than one year, and *B*'s basis for the partnership interest is \$10,000 (\$9,000 plus \$1,000, *B*'s share of partnership liabilities). None of the property owned by *PRS* is section 704(c) property. The total amount realized by *B* is \$16,000, consisting of the cash received, \$15,000, plus \$1,000, *B*'s share of the partnership liabilities assumed by *T*. See section 752. *B*'s undivided one-half interest in *PRS* includes a one-half interest in the partnership's unrealized receivables and a one-half interest in the partnership's collectibles.

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$7,000 of ordinary income from the sale of *PRS*'s unrealized receivables. Therefore, *B* will recognize \$7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital

gain or loss that the partner would realize in the absence of section 751 (\$6,000) and the amount of ordinary income or loss determined under § 1.751-1(a)(2) (\$7,000) is the partner's capital gain or loss on the sale of the partnership interest under section 741. In this case, the transferor has a \$1,000 pre-look-through long-term capital loss.

(iv) If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$1,000 of gain from the sale of the collectibles. Therefore, *B* will recognize \$1,000 of collectibles gain on account of the collectibles held by *PRS*.

(v) The difference between the transferor's pre-look-through long-term capital gain or loss (-\$1,000) and the look-through capital gain determined under this section (\$1,000) is the transferor's residual long-term capital gain or loss on the sale of the partnership interest. Under these facts, *B* will recognize a \$2,000 residual long-term capital loss on account of the sale or exchange of the interest in *PRS*.

Example 2. Special allocations. Assume the same facts as in *Example 1*, except that under the partnership agreement, all gain from the sale of the collectibles is specially allocated to *B*, and *B* transfers *B*'s interest to *T* for \$16,000. All items of income, gain, loss, or deduction of *PRS*, other than the gain from the collectibles, are divided equally between *A* and *B*. Under these facts, *B*'s amount realized is \$17,000, consisting of the cash received, \$16,000, plus \$1,000, *B*'s share of the partnership liabilities assumed by *T*. See section 752. *B* will recognize \$7,000 of ordinary income with respect to the unrealized receivables (determined under § 1.751-1(a)(2)). Accordingly, *B*'s pre-look-through long-term capital gain would be \$0. If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$2,000 of gain from the sale of the collectibles. Therefore, *B* will recognize \$2,000 of collectibles gain on account of the collectibles held by *PRS*. *B* will recognize a \$2,000 residual long-term capital loss on account of the sale of *B*'s interest in *PRS*.

Example 3. Net collectibles loss ignored. Assume the same facts as in *Example 1*, except that the collectibles held by *PRS* have an adjusted basis of \$3,000 and a fair market value of \$1,000, and the other capital assets have an adjusted basis of \$4,000 and a fair market value of \$4,000. (The total adjusted basis and fair market value of the partnership's capital assets are the same as in *Example 1*.) If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to

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the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$1,000 of loss from the sale of the collectibles. Because none of the gain from the sale of the interest in *PRS* is attributable to unrealized appreciation in the value of collectibles held by *PRS*, the net loss in collectibles held by *PRS* is not recognized at the time *B* transfers the interest in *PRS*. *B* will recognize \$7,000 of ordinary income (determined under § 1.751-1(a)(2)) and a \$1,000 long-term capital loss on account of the sale of *B*'s interest in *PRS*.

Example 4. Collectibles gain in an S corporation. (i) A corporation (*X*) has always been an S corporation and is owned by individuals *A*, *B*, and *C*. In 1996, *X* invested in antiques. Subsequent to their purchase, the antiques appreciated in value by \$300. *A* owns one-third of the shares of *X* stock and has held that stock for more than one year. *A*'s adjusted basis in the *X* stock is \$100. If *A* were to sell all of *A*'s *X* stock to *T* for \$150, *A* would realize \$50 of pre-look-through long-term capital gain.

(ii) If *X* were to sell its antiques in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer to *T*, *A* would be allocated \$100 of gain on account of the sale. Therefore, *A* will recognize \$100 of collectibles gain (look-through capital gain) on account of the collectibles held by *X*.

(iii) The difference between the transferor's pre-look-through long-term capital gain or loss (\$50) and the look-through capital gain determined under this section (\$100) is the transferor's residual long-term capital gain or loss on the sale of the S corporation stock. Under these facts, *A* will recognize \$100 of collectibles gain and a \$50 residual long-term capital loss on account of the sale of *A*'s interest in *X*.

Example 5. Sale or exchange of partnership interest where part of the interest has a short-term holding period. (i) *A*, *B*, and *C* form an equal partnership (*PRS*). In connection with the formation, *A* contributes \$5,000 in cash and a capital asset with a fair market value of \$5,000 and a basis of \$2,000; *B* contributes \$7,000 in cash and a collectible with a fair market value of \$3,000 and a basis of \$3,000; and *C* contributes \$10,000 in cash. At the time of the contribution, *A* had held the contributed property for two years. Six months later, when *A*'s basis in *PRS* is \$7,000, *A* transfers *A*'s interest in *PRS* to *T* for \$14,000 at a time when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted basis	Market value
Cash	\$22,000	\$22,000
Unrealized Receivables	0	6,000

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	ASSETS	
	Adjusted basis	Market value
Capital Asset	2,000	5,000
Collectible	3,000	9,000
Capital Assets	5,000	14,000
Total	27,000	42,000

(ii) Although at the time of the transfer *A* has not held *A*'s interest in *PRS* for more than one year, 50 percent of the fair market value of *A*'s interest in *PRS* was received in exchange for a capital asset with a long-term holding period. Therefore, 50 percent of *A*'s interest in *PRS* has a long-term holding period. See § 1.1223-3(b)(1).

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated \$2,000 of ordinary income. Accordingly, *A* will recognize \$2,000 ordinary income and \$5,000 (\$7,000-\$2,000) of capital gain on account of the transfer to *T* of *A*'s interest in *PRS*. Fifty percent (\$2,500) of that gain is long-term capital gain and 50 percent (\$2,500) is short-term capital gain. See § 1.1223-3(c)(1).

(iv) If the collectible were sold or exchanged in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated \$2,000 of gain attributable to the collectible. The gain attributable to the collectible that is allocable to the portion of the transferred interest in *PRS* with a long-term holding period is \$1,000 (50 percent of \$2,000). Accordingly, *A* will recognize \$1,000 of collectibles gain on account of the transfer of *A*'s interest in *PRS*.

(v) The difference between the amount of pre-look-through long-term capital gain or loss (\$2,500) and the look-through capital gain (\$1,000) is the amount of residual long-term capital gain or loss that *A* will recognize on account of the transfer of *A*'s interest in *PRS*. Under these facts, *A* will recognize a residual long-term capital gain of \$1,500 and a short-term capital gain of \$2,500.

(g) **Effective date.** This section applies to transfers of interests in partnerships, S corporations, and trusts that occur on or after September 21, 2000.

[T.D. 8902, 65 FR 57096, Sept. 21, 2000]

§ 1.1(i)-1T Questions and answers relating to the tax on unearned income certain minor children (Temporary).

IN GENERAL

Q-1. To whom does section 1(i) apply?

A-1. Section 1(i) applies to any child who is under 14 years of age at the